

MANAGEMENT'S DISCUSSION AND ANALYSIS (MD&A)

The following is a narrative overview and analysis of the State of North Carolina's (the State) financial performance for the fiscal year ended June 30, 2012. Please read it in conjunction with the transmittal letter at the front of this report and with the State's financial statements, which follow this section.

Financial Highlights

Government-wide Financial Statements:

- The State's total net assets increased by \$1.604 billion or 4.74% as a result of this year's operations. Net assets of governmental activities and business-type activities increased by \$1.402 billion (or 4.09%) and \$201.301 million (or 42.87%), respectively. At year-end, net assets of governmental activities and business-type activities totaled \$35.679 billion and negative \$268.284 million, respectively.
- Component units reported net assets of \$20.167 billion, an increase of \$1.043 billion or 5.45% from the previous year. The majority of the net asset increase is attributable to the University of North Carolina System, a major component unit.

Fund Financial Statements:

- The fund balance of the General Fund decreased 13.58% to \$1.022 billion at June 30, 2012. The decrease is due to the expiration of temporary taxes and significant growth in Medicaid expenditures.
- The fund balance of the Highway Fund increased 9.85% to \$629.073 million at June 30, 2012. The fund balance increase is attributable, in part, to the issuance of \$179.54 million in grant anticipation revenue vehicle bonds.
- The fund balance of the Highway Trust Fund increased from \$262.161 million at June 30, 2011 (as restated) to \$381.729 million at June 30, 2012, an increase of 45.61%.
- The Unemployment Compensation Fund reported net assets of negative \$1.969 billion at June 30, 2011 compared to negative \$1.909 billion at June 30, 2012. The improvement in net assets is attributable to the drop in the State's unemployment rate.
- Net ticket sales of the N.C. State Lottery Fund (Lottery) increased 9.38% from the previous fiscal year to \$1.596 billion. As required by law, the Lottery's net profit of \$459.469 million was transferred to the General Fund to support educational programs.
- The net assets of the N.C. Turnpike Authority increased from \$190.34 million at June 30, 2011 to \$270.357 million at June 30, 2012. The Triangle Expressway System, the State's first modern toll road, is under construction. The project is approximately 80% complete, with a 5.9% estimated savings from the initial financial plan.

Capital Assets:

- The State's investment in capital assets (net of accumulated depreciation) was \$42.092 billion, an increase of 4.9% from the previous fiscal year-end.
- This year's major capital asset additions were for State highway system construction (\$1.9 billion), toll road construction (\$325.5 million), and construction of a psychiatric hospital (\$50.3 million). Also, the State completed and placed into service a new regional medical and mental health center at Central Prison and the Green Square Complex.

Long-term Debt:

- The State had total long-term debt outstanding (bonds, special indebtedness, and notes payable) of \$8.916 billion, an increase of 5.38% from the previous fiscal year-end. The State issued \$400 million in limited obligation bonds and \$179.54 million in GARVEE bonds for its governmental activities. Additionally, the N.C. Turnpike Authority, a business-type activity, issued \$214.51 million in State appropriation revenue bonds and \$145.54 million in GARVEE bonds.
- In November 2011, all three rating agencies affirmed the triple-A credit rating for the State. The rating agencies recognized the State's historically conservative budgeting, financial management, and debt issuance practices. North Carolina remains one of only eight states with a triple-A rating from all three rating agencies.

OVERVIEW OF THE FINANCIAL STATEMENTS

This discussion and analysis is an introduction to the State's basic financial statements, which comprise three components: 1) government-wide financial statements, 2) fund financial statements, and 3) notes to the financial statements. This report also contains additional required supplementary information (General Fund budgetary schedule, pension and other postemployment benefits funding progress and contributions) and other supplementary information (combining financial statements) in addition to the basic financial statements. These components are described below.

Government-wide Financial Statements

The Statement of Net Assets and the Statement of Activities are two financial statements that report information about the State, as a whole, and about its activities that should help answer this question: Is the State, as a whole, better off or worse off as a result of this year's activities? These statements include all non-fiduciary assets and liabilities using the accrual basis of accounting. The current year's revenues and expenses are taken into account regardless of when cash is received or paid. The Statement of Net Assets (page 50) presents all of the State's assets and liabilities, with the difference between the two reported as "net assets." Over time, increases and decreases in net assets measure whether the State's financial position is improving or deteriorating.

The Statement of Activities (pages 52 and 53) presents information showing how the State's net assets changed during the most recent fiscal year. All changes in net assets are reported as soon as the underlying events giving rise to the change occur, regardless of the timing of related cash flows. Therefore, revenues and expenses are reported in these statements for some items that will only result in cash flows in future fiscal periods (e.g. uncollected taxes and earned but unused vacation leave).

Both statements report three activities:

Governmental Activities – Most of the State's basic services are reported under this category. Taxes and intergovernmental revenues generally fund these services.

Business-type Activities – The State charges fees to customers to help it cover all or most of the cost of certain services it provides. The State's Unemployment Compensation Fund, the EPA Revolving Loan Fund, the N.C. State Lottery Fund, and the N.C. Turnpike Authority are the predominant business-type activities.

Discretely Presented Component Units – Component units are legally separate organizations for which the elected officials of the primary government are financially accountable. A description of the component units and an address for obtaining their separately issued financial statements can be found beginning on page 74. All component units are combined and displayed in a separate discrete column in the government-wide financial statements to emphasize their legal separateness from the State. In addition, financial statements for major component units are presented in the notes to the financial statements (pages 159 and 160).

Fund Financial Statements

The fund financial statements provide more detailed information about the State's most significant funds (i.e., major funds) – not the State as a whole. A fund is a fiscal and accounting entity with a self-balancing set of accounts that the State uses to keep track of specific sources of funding and spending for particular purposes. In addition to the major funds, page 186 begins the individual fund data for the nonmajor funds. The State's funds are divided into three categories (governmental, proprietary, and fiduciary) and they use different accounting approaches.

Governmental funds – Most of the State's basic services are reported in the governmental funds, which focus on how cash and other financial assets that can readily be converted to cash flow in and out (i.e., inflows and outflows of spendable resources) and the balances left at year-end that are available for spending (i.e., balances of spendable resources). Consequently, the governmental fund financial statements provide a detailed short-term view that helps users determine whether there are more or fewer financial resources that can be spent in the near future to finance the State's

programs. The State prepares the governmental fund financial statements using the modified accrual basis of accounting and a current financial resources measurement focus. Because this information does not encompass the additional long-term focus of the government-wide statements, a reconciliation schedule, which follows each of the governmental fund financial statements, explains the relationships (or differences) between them. Information is presented separately in the governmental fund financial statements for the General Fund, the Highway Fund, and the Highway Trust Fund, all of which are considered to be major funds. Data for all other governmental funds are combined into a single aggregated presentation. Individual fund data for each of these nonmajor governmental funds is provided in the form of combining statements elsewhere in this report.

Proprietary funds – When the State charges customers for the services it provides, whether to outside customers or to agencies within the State, these services are generally reported in proprietary funds. Proprietary funds (enterprise and internal service) utilize accrual accounting, which is the same method used by private sector businesses. Enterprise funds are used to report activities for which fees are charged to external users for goods and services. The Unemployment Compensation Fund, the EPA Revolving Loan Fund, the N.C. State Lottery Fund, and the N.C. Turnpike Authority are our most significant enterprise funds. Internal service funds are used to report activities that provide goods and services to the State’s other programs and activities on a cost-reimbursement basis, such as the State Property Fire Insurance Fund, the Motor Fleet Management Fund, Computing Services Fund, and the State Telecommunications Services Fund. Because the State’s internal service funds predominantly benefit governmental rather than business-type functions, they have been included within governmental activities in the government-wide financial statements.

Proprietary funds provide the same type of information as the government-wide financial statements, only in more detail. Information is presented separately in the proprietary fund financial statements for the Unemployment Compensation Fund, the EPA Revolving Loan Fund, the N.C. State Lottery Fund, and the N.C. Turnpike Authority, all of which are considered to be major funds. Conversely, separately aggregated columns are presented for the nonmajor enterprise funds and the internal service funds. Individual fund data for the nonmajor enterprise funds and internal service funds is provided in the form of combining statements elsewhere in this report.

Fiduciary funds – Fiduciary funds are used to account for resources held for the benefit of parties outside the government. Fiduciary funds are not reflected in the government-wide financial statements because the resources of those funds are not available to support the State’s own programs. The accounting used for fiduciary funds is much like that used for proprietary funds. The State’s fiduciary activities are reported in separate Statements of Fiduciary Net Assets and Changes in Fiduciary Net Assets. These funds include pension and other employee benefit trust funds, private-purpose trust funds, investment trust funds, and agency funds.

Notes to the Financial Statements

The notes provide additional information that is essential to a full understanding of the data provided in the government-wide and fund financial statements. The notes to the financial statements can be found beginning on page 72 of this report.

Required Supplementary Information

Required Supplementary Information (RSI) follows the basic financial statements and notes to the financial statements. The RSI is mandated by the GASB and includes General Fund budgetary comparison schedules reconciling the statutory to the generally accepted accounting principles fund balances at fiscal year-end, and pension plan and other postemployment benefits trend information related to funding progress and contributions.

Other Supplementary Information

Other supplementary information includes the introductory section; combining financial statements for nonmajor governmental funds, nonmajor enterprise funds, internal service funds, fiduciary funds, and nonmajor discretely presented component units; a statement of cash flows for the State Health Plan, a major component unit, which does not issue separate financial statements; and the statistical section.

FINANCIAL ANALYSIS OF THE STATE AS A WHOLE

Over time, increases or decreases in net assets serve as a useful indicator of whether a government's financial position is improving or deteriorating. The State's combined net assets increased \$1.604 billion or 4.74% over the course of this fiscal year's operations. The net assets of the governmental activities increased \$1.402 billion or 4.09% and business-type activities increased \$201.301 million or 42.87%. The following table was derived from the government-wide Statement of Net Assets:

Net Assets June 30, 2012 and 2011 (dollars in thousands)

	Governmental Activities		Business-type Activities		Total Primary Government		Total Percentage Change
	2012	2011 (as restated)	2012	2011 (as restated)	2012	2011 (as restated)	2012-2011
Current and other non-current assets.....	\$ 8,958,890	\$ 8,911,882	\$ 3,302,000	\$ 2,901,625	\$ 12,260,890	\$ 11,813,507	3.79%
Capital assets, net.....	41,030,462	39,388,292	1,061,581	738,518	42,092,043	40,126,810	4.90%
Total assets.....	49,989,352	48,300,174	4,363,581	3,640,143	54,352,933	51,940,317	4.64%
Long-term liabilities.....	9,055,542	8,939,185	4,164,764	3,705,077	13,220,306	12,644,262	4.56%
Other liabilities.....	5,255,195	5,084,644	467,101	404,651	5,722,296	5,489,295	4.24%
Total liabilities.....	14,310,737	14,023,829	4,631,865	4,109,728	18,942,602	18,133,557	4.46%
Net assets:							
Invested in capital assets, net of related debt.....	38,699,112	37,338,472	391,878	294,172	39,090,990	37,632,644	3.88%
Restricted.....	728,971	730,021	1,468	3,131	730,439	733,152	(0.37%)
Unrestricted.....	(3,749,468)	(3,792,148)	(661,630)	(766,888)	(4,411,098)	(4,559,036)	(3.24%)
Total net assets.....	\$ 35,678,615	\$ 34,276,345	\$ (268,284)	\$ (469,585)	\$ 35,410,331	\$ 33,806,760	4.74%

The largest component of the State's net assets (\$39.091 billion) reflects its investment in capital assets (land, buildings, machinery and equipment, state highway system, and other capital assets), less related debt still outstanding that was used to acquire or construct those assets. Restricted net assets are the next largest component (\$730.439 million). Net assets are restricted when constraints placed on their use are 1) externally imposed by creditors, grantors, contributors, or laws or regulations of other governments or 2) legally imposed through constitutional provisions. The remaining portion, unrestricted net assets, consists of net assets that do not meet the definition of "restricted" or "invested in capital assets, net of related debt."

The government-wide statement of net assets for governmental activities reflects a negative \$3.749 billion unrestricted net asset balance. The State of North Carolina, like many other state and local governments, issues general obligation debt and special indebtedness and distributes the proceeds to local governments and component units. The proceeds are used to construct new buildings and renovate and modernize existing buildings on the State's community college and university campuses, assist county governments in meeting their public school building capital needs, and to provide grants and loans to local governments for clean water and natural gas projects. Of the \$7.711 billion of bonds and special indebtedness outstanding for governmental activities at June 30, 2012, \$5.25 billion is attributable to debt issued as state aid to component units (universities and community colleges) and local governments. The balance sheets of component unit and local government recipients reflect ownership of the related constructed capital assets without the burden of recording the debt obligation. The policy of selling general obligation bonds and funneling the cash proceeds to non-primary government (non-State) entities has been in place for decades. However, by issuing such debt, the State is left to reflect significant liabilities on its statement of net assets (reflected in the unrestricted net asset component) without the benefit of recording the capital assets constructed or acquired with the proceeds from the debt issuances. Additionally, as of June 30, 2012, the State's governmental activities have significant unfunded liabilities for compensated absences of \$409.381 million, worker's compensation of \$136.732 million, and a court judgment payable of \$731.703 million (see Note 8 to the financial statements). In 2008, a Superior Court judge ruled that certain civil fines and penalties should have been remitted to North Carolina public schools and not diverted to other uses. These unfunded liabilities also contribute to the negative unrestricted net asset balance for governmental activities.

The following financial information was derived from the government-wide Statement of Activities and reflects how the State's net assets changed during the fiscal year:

Changes in Net Assets
For the Fiscal Years Ended June 30, 2012 and 2011
(dollars in thousands)

	Governmental Activities		Business-type Activities		Total Primary Government		Total Percentage Change
	2012	2011 (as restated)	2012	2011 (as restated)	2012	2011 (as restated)	2012-2011
Revenues:							
Program revenues:							
Charges for services.....	\$ 2,098,728	\$ 2,076,094	\$ 3,212,802	\$ 2,900,871	\$ 5,311,530	\$ 4,976,965	6.72%
Operating grants and contributions.....	15,599,541	15,632,256	1,966,030	2,998,116	17,565,571	18,630,372	(5.72%)
Capital grants and contributions.....	977,961	1,198,549	15,436	11,687	993,397	1,210,236	(17.92%)
General revenues:							
Taxes							
Individual income tax.....	10,459,307	10,020,535	—	—	10,459,307	10,020,535	4.38%
Corporate income tax.....	1,233,989	1,132,931	—	—	1,233,989	1,132,931	8.92%
Sales and use tax.....	5,530,046	6,172,377	—	—	5,530,046	6,172,377	(10.41%)
Gasoline tax.....	1,892,163	1,675,476	—	—	1,892,163	1,675,476	12.93%
Franchise tax.....	804,973	794,091	—	—	804,973	794,091	1.37%
Highway use tax.....	506,211	469,811	—	—	506,211	469,811	7.75%
Insurance tax.....	479,755	501,032	—	—	479,755	501,032	(4.25%)
Beverage tax.....	322,190	311,809	—	—	322,190	311,809	3.33%
Inheritance tax.....	57,839	24,184	—	—	57,839	24,184	139.16%
Tobacco products tax.....	293,597	291,699	—	—	293,597	291,699	0.65%
Other taxes.....	294,516	301,217	—	—	294,516	301,217	(2.22%)
Tobacco settlement.....	146,135	131,318	—	—	146,135	131,318	11.28%
Unrestricted investment earnings.....	(56,055)	32,980	—	—	(56,055)	32,980	(269.97%)
Miscellaneous.....	41,699	45,014	—	3	41,699	45,017	(7.37%)
Total revenues.....	40,682,595	40,811,373	5,194,268	5,910,677	45,876,863	46,722,050	(1.81%)
Expenses:							
General government.....	937,353	1,209,923	—	—	937,353	1,209,923	(22.53%)
Primary and secondary education.....	9,760,909	10,024,775	—	—	9,760,909	10,024,775	(2.63%)
Higher education.....	4,238,695	4,350,475	—	—	4,238,695	4,350,475	(2.57%)
Health and human services.....	17,759,093	16,859,438	—	—	17,759,093	16,859,438	5.34%
Economic development.....	667,106	744,703	—	—	667,106	744,703	(10.42%)
Environment and natural resources.....	470,965	596,227	—	—	470,965	596,227	(21.01%)
Public safety, corrections and regulation.....	2,976,448	2,729,418	—	—	2,976,448	2,729,418	9.05%
Transportation.....	2,403,266	2,177,062	—	—	2,403,266	2,177,062	10.39%
Agriculture.....	188,985	114,275	—	—	188,985	114,275	65.38%
Interest on long-term debt.....	282,542	306,696	—	—	282,542	306,696	(7.88%)
Unemployment compensation.....	—	—	3,283,900	4,420,762	3,283,900	4,420,762	(25.72%)
N.C. State Lottery.....	—	—	1,141,941	1,028,536	1,141,941	1,028,536	11.03%
EPA Revolving Loan.....	—	—	14,026	42,897	14,026	42,897	(67.30%)
N.C. Turnpike Authority.....	—	—	17,565	4,940	17,565	4,940	255.57%
Regulatory programs.....	—	—	69,980	80,454	69,980	80,454	(13.02%)
Insurance programs.....	—	—	38,701	36,885	38,701	36,885	4.92%
North Carolina State Fair.....	—	—	13,030	13,595	13,030	13,595	(4.16%)
Other business-type activities.....	—	—	12,084	9,148	12,084	9,148	32.09%
Total expenses.....	39,685,362	39,112,992	4,591,227	5,637,217	44,276,589	44,750,209	(1.06%)
Increase (decrease) in net assets before contributions and transfers.....	997,233	1,698,381	603,041	273,460	1,600,274	1,971,841	(18.84%)
Contributions to permanent funds.....	3,297	3,188	—	—	3,297	3,188	3.42%
Transfers.....	401,740	371,424	(401,740)	(371,424)	—	—	0.00%
Increase (decrease) in net assets.....	1,402,270	2,072,993	201,301	(97,964)	1,603,571	1,975,029	(18.81%)
Net assets - beginning - restated.....	34,276,345	32,203,352	(469,585)	(371,621)	33,806,760	31,831,731	6.20%
Net assets - ending.....	\$ 35,678,615	\$ 34,276,345	\$ (268,284)	\$ (469,585)	\$ 35,410,331	\$ 33,806,760	4.74%

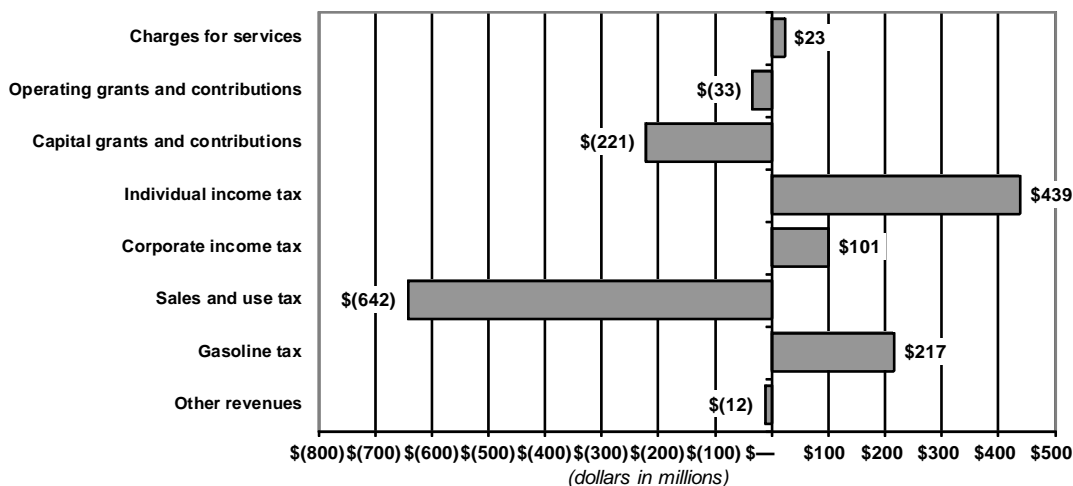
Governmental Activities

For fiscal year 2012, revenues outpaced expenses and when combined with transfers from the State's business-type activities, an increase in net assets of \$1.402 billion (or 4.09%) resulted for governmental activities. While total revenues decreased by less than one percent (\$128.78 million), total expenses increased by 1.46% (\$572.37 million). The decrease in total revenues is attributable mainly to the expiration of temporary tax increases enacted by the N.C. General Assembly and significant reductions in federal recovery funds (see below paragraph). The decrease in total revenues was partially offset by increases in individual income taxes, gasoline taxes, and other taxes. The increase in individual income taxes is an indication that the State's economy is slowly turning in a positive direction. The increase in gasoline taxes is due to a higher average tax rate as a result of higher wholesale prices during the fiscal year.

On February 17, 2009 the U.S. Congress enacted the American Recovery and Reinvestment Act of 2009 (ARRA). A direct response to the economic crisis, the ARRA has three immediate goals: 1) create new jobs as well as save existing ones, 2) spur economic activity and invest in long-term economic growth, and 3) foster unprecedented levels of accountability and transparency in government spending. To help achieve these goals, the ARRA provided supplemental funding to states for budget stabilization, entitlement programs (Medicaid and extension of unemployment benefits), and other purposes. The ARRA specifies that most of the funds be distributed over three years: 2009, 2010, and 2011. In response to this legislation, the Governor established the North Carolina Office of Economic Recovery and Investment to coordinate the State's handling of ARRA funds and state-level economic recovery initiatives. The ARRA also provides funding for the Race to the Top Fund, a competitive grant program designed to encourage and reward states that create conditions for education innovation and reform. North Carolina secured \$400 million in federal Race to the Top grants in 2010 to be spent over four years through the 2014 school year. North Carolina also won \$70 million in early childhood grants in 2011. During the current and previous fiscal years, the State's governmental activities recognized \$658.57 million and \$2.27 billion of ARRA funds, respectively (federal recovery funds), which are included in operating grants and contributions (i.e., program revenues).

The following chart reflects the dollar change in the revenues by source of governmental activities between fiscal years 2011 and 2012:

**Dollar Change in Governmental Activities Revenues by Source
Between Fiscal Years 2011 and 2012**



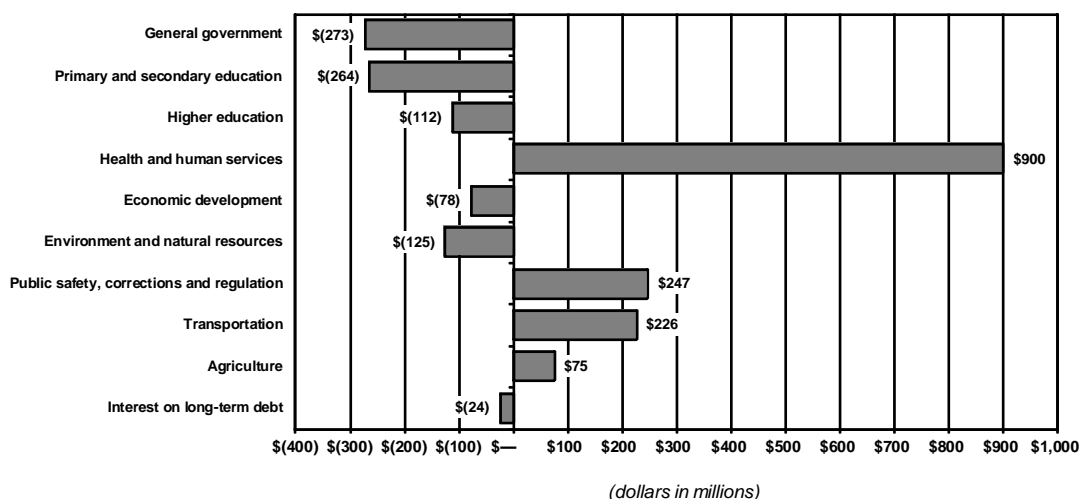
For fiscal year 2012, spending increases in the functional areas of health and human services; public safety, corrections, and regulation; transportation; and agriculture were partially offset by spending decreases in the State's other functional areas. The growth in health and human services is primarily due to increased spending for Medicaid (the State's largest public assistance program). However, total operating grants and contributions decreased because the primary ARRA funding streams ended in fiscal year 2011.

Medicaid is a federal entitlement program, which means individuals found eligible for Medicaid have legal rights to receive services and cannot be denied coverage by the State. In North Carolina, Medicaid is administered by the State and counties and financed with federal and State funds. Medicaid serves as the State's safety net program for eligible individuals who lose jobs and health insurance coverage. As such, it is sensitive to economic volatility. Higher growth rates occur during years of economic distress and when major Medicaid expansions are enacted. Lower growth rates occur when the Medicaid eligible population is stable or declining.

The growth in public safety, corrections, and regulation is due to the consolidation of the Department of Juvenile Justice and Delinquency Prevention (Juvenile Justice) into the new State Department of Public Safety. In the prior fiscal year, expenses of Juvenile Justice were classified as health and human services. Construction activity on various intrastate and secondary routes accounted for the majority of the spending increase in transportation. The spending decreases in the remaining functional areas are explained by the significant reductions in ARRA funding mentioned previously and by the significant spending reductions enacted by the N.C. General Assembly in the fiscal year 2012 budget.

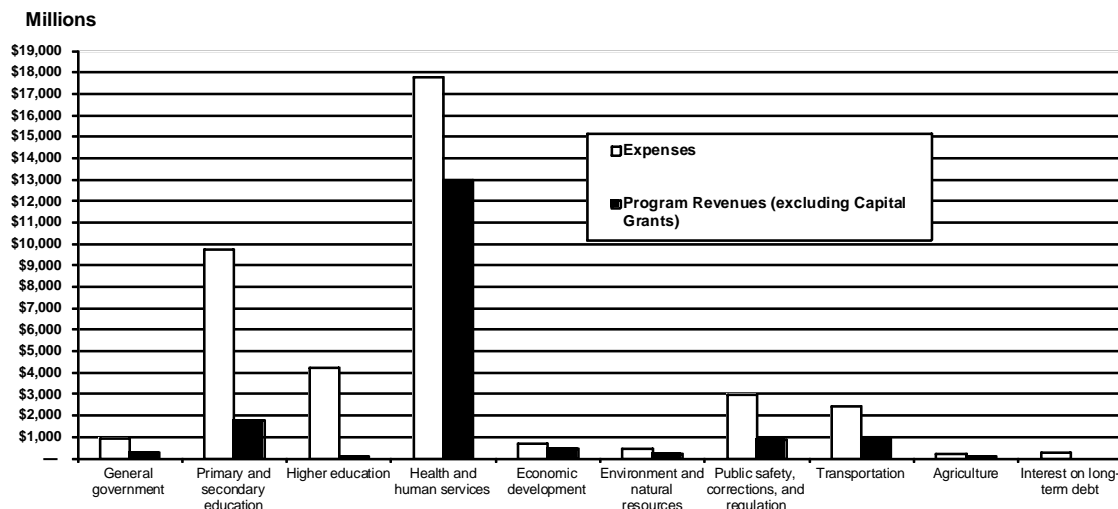
The following chart reflects the dollar change in the functional expenses of governmental activities between fiscal years 2011 and 2012:

**Dollar Change in Governmental Activities Functional Expenses
Between Fiscal Years 2011 and 2012**



The following chart depicts the total expenses and total program revenues of the State's governmental functions. This format identifies the extent to which each governmental function is self-financing through fees and intergovernmental aid or draws from the general revenues of the State.

**Expenses - Governmental Activities
For the Fiscal Year Ended June 30, 2012**



***Business-type
Activities***

Business-type activities reflect an overall increase in net assets of \$201.301 million or 42.87%, primarily because of the financial results of the Unemployment Compensation Fund, the N.C. Turnpike Authority, and the EPA Revolving Loan Fund, respectively. The net asset increase of \$59.41 million in the Unemployment Compensation Fund is explained by the drop in the State's unemployment rate. The net asset increase of \$80.017 million for the N.C. Turnpike Authority is due to capital contributions from the Federal Highway Administration and transfers in from the Highway Trust Fund. The net asset increase of \$67.107 million in the EPA Revolving Loan Fund is due to the recognition of federal capitalization grants and federal recovery funds. The N.C. State Lottery Fund has no net assets since its net profits are distributed to the State's governmental activities, as required by statute. A more detailed discussion of the State's business-type enterprise activities is provided in the following section (see Enterprise Funds).

FINANCIAL ANALYSIS OF THE STATE'S FUNDS

The State uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements.

Governmental Funds

The focus of the State's governmental funds is to provide information on near-term inflows, outflows, and balances of spendable resources. At June 30, 2012, the State's governmental funds reported combined fund balances of \$3.499 billion, a decrease of 3.34% from the prior fiscal year-end (as restated). This amount includes negative unassigned fund balances of \$63.614 million. The remainder of fund balance is either nonspendable, restricted, committed, or assigned to indicate that it is not available for new spending. The negative unassigned fund balances are due to nonspendable, restricted, and committed fund balances exceeding total fund balances. The major governmental funds are discussed individually below.

General Fund

The General Fund is the chief operating fund of the State. The fund balance of the General Fund declined 13.58% to \$1.022 billion at June 30, 2012. The decrease is due to the expiration of temporary taxes and significant growth in Medicaid expenditures. At the end of the current fiscal year, unassigned fund balance of the General Fund was negative \$62.303 million.

Individual income tax and corporate income tax revenues increased by 4.38% and 4.85% respectively, while sales and use tax revenues decreased by 10.07%. All individual income tax payment types (i.e., final payments by individuals, withholdings by employers, and estimated payments by individuals) increased during the current fiscal year. This trend shows that the economy is slowly turning in a positive direction. The largest tax change for fiscal year 2011-12 was the expiration of the temporary tax package passed as part of the 2009-2011 biennium budget. This package included a 1% increase in the state sales tax (expired on July 1, 2011), a 2% or 3% income tax surcharge on highest-income households (expired for taxable years on or after January 1, 2011), and a 3% surcharge on corporate income taxes (expired for taxable years on or after January 1, 2011). Allowing the package to expire decreased annual State revenue by an estimated \$1.3 billion.

The General Assembly enacted Session Law 2011-15 (Senate Bill 109), which required the Governor to cut spending for fiscal year 2010-11 and to increase General Fund availability for fiscal year 2011-12 by \$538 million. Special exceptions were made for high need programs including prisons, Medicaid, and public schools. This legislation was in response to an anticipated budget shortfall for fiscal year 2011-12 of approximately \$2.6 billion. The General Assembly enacted a \$19.7 billion appropriation budget for fiscal year 2011-12, closing the \$2.6 billion budget gap through spending reductions (64%) and adjustments to availability (36%). Spending reductions totaled \$2.1 billion. The largest reductions occurred in the functional areas of education (\$1.2 billion) and health and human services (\$531 million). Adjustments increased availability by \$354 million. Major adjustments to availability included transfers from the Highway Fund for State Highway Patrol (\$197 million), increases in judicial fees (\$62 million), and suspension of the corporate earmark for public school construction (\$72 million).

During the current and previous fiscal years, the General Fund recognized federal recovery funds provided under the American Recovery and Reinvestment Act of 2009 (ARRA) of \$421.815 million and \$1.791 billion, respectively. ARRA includes two key funding streams for states, the State Fiscal Stabilization Fund (SFSF) and increased federal participation in Medicaid (FMAP). The SFSF is a one-time federal appropriation intended to help stabilize state and local government budgets in order to minimize layoffs and disruptions in education and other essential public services. The FMAP is a temporary increase to states in the federal share of Medicaid costs. Each state's increase in FMAP is based on the increase in unemployment percentages for each quarter. The federal recovery funds were used to avoid deeper reductions in spending. The ARRA funding streams for the SFSF and FMAP ended in fiscal year 2010-11.

One of the major budget drivers for the General Fund is the Medicaid Program. On the budget basis, expenditures for Medicaid increased 22.76% in fiscal year 2011-12 to \$3.03 billion. The significant increase is due to the reduced federal participation in Medicaid (see previous page) and a Medicaid budget shortfall. The fiscal year 2011-12 certified budget fell short by \$375 million of the amount needed to provide Medicaid services for the entire fiscal year. This increase is explained by unbudgeted liabilities (i.e., over-collection of federal funding in fiscal year 2008-09), unachievable budget reductions, and an increase in Medicaid enrollment. The Medicaid Program was directed by Session Law 2011-145 to achieve savings through various optional service changes. However, due to the length of time necessary for application to and approval by the Centers for Medicare and Medicaid Services (CMS), budget reductions were not achieved. In addition, Medicaid enrollment increased by 4.6% during the current fiscal year. The percentage of Medicaid participants grew from 15.2% of the North Carolina population in the prior fiscal year to an estimated 15.8% of the State's population in the current fiscal year. To assist with the Medicaid shortfall, the N.C. General Assembly enacted legislation that transferred funds to the Medicaid Program from sources such as the Repairs and Renovations Reserve and agency reversions.

During the current fiscal year, specific actions to mitigate the growing population and expenditures in Medicaid included 1) a two percent annual rate reduction, 2) changes in payment policies to offset cost and inflationary increases in rate methodologies, 3) implementation of new provider assessment programs, 4) application for a new CMS initiative to enhance Federal Medical Assistance Percentage, 5) modification of pharmacy policies and payments to reduce costs and increase generic prescribing, 6) modification of clinical coverage policies for selected services, and 7) other program changes. All policies and changes were implemented in a manner to ensure continued access to quality services for the Medicaid enrollees.

General Fund Budget Variances

The original General Fund budget, including state appropriations and appropriations supported by departmental receipts, serves as a starting point or plan for the Governor to execute the General Fund budget pursuant to the powers granted by the State Budget Act. At the state level in North Carolina, it is not unusual for the budget to change during the fiscal year in relation to budget adjustments made to accommodate departmental receipts. The General Fund budget supported by state appropriation is a subset of the General Fund financial schedule presented in the CAFR as required supplementary information. The current CAFR schedule reflects all spending required to support the State's General Fund activities and the funding to support those activities, including state tax and non-tax revenues, federal revenues, student tuition, and other fees, licenses, and fines. Under current state budget management practice, particularly related to departmental federal receipts, primary emphasis is placed on comparisons of the final authorized budget and actual spending.

At the state level, budgetary cuts related to state appropriations are implemented by decreasing allowable actual expenditures, as opposed to decreasing the state appropriation through a formal legislative process. The Governor and state agencies maintain legal authority to spend the dollars originally appropriated to them; however, in recent years the actual spending has been limited by the collection of tax and nontax revenue. In extremely rare cases, the General Assembly has held special sessions to formally amend the state appropriation budget.

The portion of the original budget comprising departmental receipts is not intended to be the sole controlling point to manage the State's General Fund budget. The final budget includes amendments for departmental receipts collected during the fiscal year as allowed by law. General Fund departmental receipts are typically authorized for expenditure within the activity that generated the receipt. Historically, final estimated receipts have varied significantly from the original estimate at the beginning of the fiscal year. State agencies by law must spend departmental receipts prior to spending tax and nontax supported appropriations. If departmental receipts are higher than expected, appropriated dollars may go unspent and be re-appropriated in a subsequent fiscal year.

Variances – Original and Final Budget

In general, the variances between original and final budget are attributable to the timing and length of the budget preparation process and the budgeting of ARRA funds for the fiscal year. The original

budget for fiscal year 2011-12 was prepared approximately 18 months prior to the final budget existing at June 30, 2012. The final budget reflects all budget revisions made throughout the fiscal year to adjust for known facts as well as supplemental adjustments approved in the 2011 Session of the General Assembly. Consequently, when the original budget is compared to the final budget, it would be expected that significant variances can occur.

Additional factors leading to variances between original and final budget in fiscal year 2011-12 include the following:

- 1) Awarding of new unanticipated federal grants and/or the awarding of unanticipated increased or decreased amounts in long-standing federally supported programs. This also led to the necessity of budgeting unanticipated required state match.
- 2) Statewide encumbrance carry-forward budgeted amounts from fiscal year 2010-11 totaled \$127.1 million.
- 3) Allocation of statewide reserves to agencies and universities for the purposes of retirement and hospitalization formula adjustments, contingency and emergency, information technology related programs, and various other budgeted statewide reserves.
- 4) Receipt and budgeting of over-realized receipts, prior year earned revenues, and unanticipated donations and grants.
- 5) Budgeting of federal ARRA funds that increased the final revenue and expenditure budgets.

Variances - Final Budget and Actual Results

Actual total revenue collected (both tax and non-tax, excluding departmental) exceeded budgeted amounts in fiscal year 2011-12. This primarily occurred because North Carolina adopted a cautious revenue outlook for fiscal year 2011-12 and the economy performed slightly better than anticipated. In particular, income, gains, and profits exceeded expectations and translated into better than expected individual income tax and corporate income tax collections, two of North Carolina's largest and most volatile revenue sources. Sales and use tax collections, however, finished the fiscal year slightly below forecast as the labor market struggled to gain consistent momentum.

Departmental federal funds actually received by agencies were less than the final authorized budgeted federal fund revenues. A variance between the budget and actual federal funds occurs because actual federal fund receipts are reflective of the actual expenditures. Therefore, if qualifying federal costs are not incurred by an agency, the actual receipt of federal funds could be significantly less than the budget.

Highway Fund

The Highway Fund dates back to 1921, which is when the General Assembly first imposed the gasoline tax. It accounts for most of the activities of the North Carolina Department of Transportation (NCDOT), including the maintenance and construction of the State's primary and secondary road systems, the Division of Motor Vehicles, the State Highway Patrol, transit, rail and ferry system. The primary revenue sources of the Highway Fund are federal funds, three-fourths of gasoline taxes, vehicle registration fees, and driver's license fees.

The fund balance of the Highway Fund increased from \$572.667 million at June 30, 2011 (as restated) to \$629.073 million at June 30, 2012, an increase of 9.85%. The fund balance increase is attributable, in part, to the issuance of \$179.54 million in grant anticipation revenue vehicle bonds (GARVEE's) in January 2012. This innovative financing tool was used to accelerate the funding of transportation improvement projects across the State by leveraging future federal transportation revenues. At June 30, 2012, \$88.41 million of the GARVEE proceeds were unspent.

Total revenues decreased by \$24.73 million or less than one percent. Gasoline taxes increased by 12.88%; however, this increase was more than offset by decreases in federal recovery funds. While overall fuel consumption decreased slightly during the year, gasoline taxes increased due to a 4.75 cent increase in the average tax rate as a result of higher wholesale prices during the fiscal year. By the end of fiscal year 2011, over 80% of federal recovery funds for highway infrastructure had been exhausted. As a result, billings for 2012 were less than the previous year. Total expenditures increased by less than one percent.

Population growth is placing an increasing demand on the State's transportation system. North Carolina's population grew from 8.05 million in 2000 to 9.69 million in 2012, an increase of 21.49%. The U.S. Census estimates North Carolina's population growing to approximately 12.2 million by 2030, which would place the state as the seventh most populated state in the country. According to the 2010 Report on the Condition of the State Highway System prepared by the N.C. Division of Highways, over a 10 year period (2001 to 2010), the number of paved miles increased by almost 4% and the square footage of bridge deck area grew by over 24%. During this same 10 year period, vehicle miles traveled increased by over 15%. While the recent recession slowed the growth in vehicle miles traveled, it is anticipated this rate will return to pre-recession growth. This increase places a heavier burden on the existing infrastructure and accentuates the need for additional capacity, safety, and maintenance funding to address the deterioration in service created by the increase in traffic. Furthermore, many of the State's highways were built as farm-to-market roads and were not designed to handle the heavy traffic volumes of today, and other highways such as the interstate highway system, which has celebrated its 50th anniversary, are nearing the end of their functional life.

Transportation is fundamental in continuing North Carolina's prosperity and quality of life as the state's population continues to grow. To address the growing demand on the transportation system, increased cost of supplies, and declining funding, NCDOT continues to seek innovative solutions to meet the growing stress on the transportation system. In response to declining motor fuels tax and the decreasing purchasing power of the Highway Fund, Session Law 2009-108 repealed the cap on the motor fuels tax and set the variable portion of the tax at 12.4 cents per gallon or 7% of the average wholesale price whichever is greater, thus setting a floor of 29.9 cents per gallon. This remained in place through June 30, 2011. Session Law 2012-142 reinstated the cap on the motor fuels tax at a rate of 37.5 cents per gallon effective July 1, 2012 until June 30, 2013.

Highway Trust Fund

Legislation creating the Highway Trust Fund was passed by the General Assembly in 1989. It was established to provide a dedicated funding mechanism to meet a specific set of highway construction needs in North Carolina. Additionally, the Highway Trust Fund provides supplemental allocations for secondary road construction, supplemental assistance to municipalities for local street projects, and pays the debt service on the State's general obligation bonds issued for highway purposes.

The principal revenue sources of the Highway Trust Fund are highway use taxes, one-fourth of gasoline taxes, and various title and registration fees. The enabling legislation also specifies that a designated amount will be transferred each year to the General Fund. The amounts transferred to the General Fund for fiscal years 2012 and 2011 were \$76.721 million and \$72.895 million, respectively. The enabling legislation was amended in 2008 to also require annual transfers to the N.C. Turnpike Authority to pay debt service or financing expenses for specified toll road construction projects (see Note 10(B) to the financial statements).

The fund balance of the Highway Trust Fund increased from \$262.161 million at June 30, 2011 (as restated) to \$381.729 million at June 30, 2012, an increase of 45.61%. Total revenues increased by \$91.72 million or 9.39%, primarily because of increases in gasoline taxes and highway use taxes. While overall fuel consumption decreased slightly during the year, gasoline taxes increased due to a 4.75 cent increase in the average tax rate as a result of higher wholesale prices during the fiscal year. Highway use taxes increased primarily due to growth in new vehicle sales. Total transportation expenditures increased by \$94.12 million or 15.82%. Construction activity on various intrastate and secondary routes along with the Yadkin River bridge project accounted for the majority of this increase.

The 2010 Report on the Condition of the State Highway System also noted that since passage of the Highway Trust Fund in 1989, the NCDOT has paved over 11,000 miles of unpaved secondary roads, leaving only 4,500 miles of secondary roads to be paved. In view of the fact that the paved secondary road system has not kept up with the demands of increased urbanization and traffic, the 2006 Session of the General Assembly approved changes in the General Statutes that govern the use of secondary road construction funds. Beginning with fiscal year 2010-2011, secondary road allocations to the counties are based on the total number of secondary road miles in that county in proportion to the total State maintained secondary road mileage.

**Enterprise
Funds**

The State's enterprise funds or business-type activities provide the same type of information found in the government-wide financial statements, but in more detail. The major enterprise funds are discussed individually below.

Unemployment Compensation Fund

The Unemployment Compensation Fund (Trust Fund) reported net assets of negative \$1.969 billion at June 30, 2011 compared to negative \$1.909 billion at June 30, 2012. The improvement in net assets is explained primarily by the drop in the State's unemployment rate from 10.6% in June 2011 to 9.4% in June 2012. The Trust Fund's operating margin (operating revenues less operating expenses) was negative \$1.719 billion this year compared to negative \$3.074 billion in 2011. Unemployment benefit expenses (both State and Federal) decreased 26.92% in fiscal year 2011-12 to \$3.192 billion, primarily due to claimants exhausting their maximum allowable benefits and a reduction in the number of new initial claims.

In February 2009, because of depleted cash balances, the State began borrowing from the U.S. Treasury to ensure the uninterrupted payment of State unemployment benefits. At June 30, 2012, the repayable advances from the State's Federal Unemployment Account totaled \$2.566 billion compared to \$2.536 billion at the previous fiscal year-end. Interest began accruing January 1, 2012 at an interest rate of 2.94%. Interest is due and payable on September 30 for each year that the loan has an outstanding balance. The required interest payment of \$84 million was made on September 30, 2012. A 20% surcharge on unemployment contributions, which has been in effect since January 1, 2005 as required by statute, remained in effect during the current fiscal year. The surcharge is deposited into the State Reserve Fund and one of the allowable uses is to pay the interest on the borrowing. The surcharge is still in effect because the balance in the Trust Fund has not reached the trigger "off" level.

During fiscal year 2011-12, the federal government continued to provide various types of assistance to the unemployed but the total assistance decreased significantly. Consequently, nonoperating revenues decreased 34.22% to \$1.888 billion. The multiple types of assistance, classified as nonoperating revenues, are as follows:

1. The federal Emergency Unemployment Compensation program provided \$1.536 billion in benefits this fiscal year (compared to \$2.271 billion last year).
2. The Extended Benefit (EB) and High Unemployment Period 100% programs provided payments that totaled \$283.718 million this fiscal year (compared to \$458 million last year). These benefits were provided under the American Recovery and Reinvestment Act.

For the tax year 2012, the Federal Unemployment Tax increased by 0.3% because the State had an outstanding loan in January for two consecutive years and did not pay back the borrowing. The funds generated from this federal tax increase go directly towards paying down the loan (i.e., Federal unemployment account advances). The additional federal taxes paid by the State's employers this fiscal year, which were used to reduce the loan, was \$68.329 million (classified as gain on extinguishment of debt). The Federal Unemployment Tax will increase by 0.3% for each succeeding year until the loan is repaid.

N.C. State Lottery Fund

The N.C. Education Lottery (NCEL) first began selling game tickets in 2006. As required by the enabling legislation, net revenues of the NCEL are transferred four times a year to the General Fund. The NCEL transferred \$459.469 million to the General Fund in 2012 to support educational programs for the State. The amount transferred in 2011 was \$436.241 million. At year end, the net assets of the NCEL are zero. The NCEL has no changes in the net assets from year to year.

For fiscal year 2011-12, net ticket sales increased 9.38% from the previous fiscal year to \$1.596 billion. Significant financial highlights include the following: awarded \$1 million or more to an NCEL player for the 110th time; increased the number of retailers to 6,787, representing a 2.7% increase over the prior year; and released 49 new instant scratch-off games into the marketplace generating gross instant ticket sales of \$960 million.

The NCEL's 2012-13 budget provides for a projected \$442 million transfer to the General Fund, representing a 3.9% increase from the previous year's budget. As established in the enabling legislation, lottery funds are to be distributed for educational purposes as follows:

1. 67% to support reduction of class size in early grades and to support pre-kindergarten programs for at-risk four-year-olds who would otherwise not be served in high quality settings (*Note: to date, these programs have been funded by the General Fund*).
2. 23% for public school construction.
3. 10% to the State Education Assistance Authority to fund college and university scholarships.

N.C. Turnpike Authority

The North Carolina Turnpike Authority (NCTA) was created in 2002 by the General Assembly in response to concerns about rapid growth, heavy congestion and dwindling resources. It is authorized to study, plan, develop, construct, operate and maintain up to eight turnpike projects. Major accomplishments for the NCTA for fiscal year 2011-12 included the following:

- The Triangle Expressway System, North Carolina's first modern toll road, is under construction and being completed in three stages. The Triangle Parkway (Phase I) is 3.4 miles of new construction and was completed ahead of schedule and opened to traffic in December 2011. The Western Wake Freeway (Phases II and III) includes 12.6 miles of new construction. Phase II opened in August 2012 and Phase III is expected to open in December 2012. The Triangle Expressway System includes the construction of an integrated, electronic tolling system. As of June 30, 2012, the project is approximately 80% complete, with a 5.9% estimated savings from the initial financial plan.
- The NCTA has completed the financing for the Monroe Connector System, a 20 mile toll road in Mecklenburg and Union counties. However, construction has been delayed due to litigation challenging the project's environmental documentation.

Funding for administrative expenses is being advanced as needed from the Highway Trust Fund to be repaid from NCTA revenue collections. Interest on the advances will begin to accrue one year after the NCTA begins collecting tolls on a completed turnpike project.

The high cost of building, operating and maintaining a major highway facility is typically more than the revenue a new road can generate through tolls. The gap between what tolling can pay for and the cost of the road requires additional support from the State, known as gap funding. In 2008, the General Assembly enacted legislation authorizing annual transfers from the Highway Trust Fund to the NCTA to pay debt service and fund required reserves on bonds issued to finance turnpike projects. For fiscal years 2012 and 2013, the N.C. General Assembly appropriated \$49 million annually for the Triangle Expressway and Monroe Connector projects.

EPA Revolving Loan Fund

The net assets of the EPA Revolving Loan Fund increased by \$67.107 million or 5.73% from the prior fiscal year-end. Operating income was \$15.674 million (operating revenues less operating expenses). Net nonoperating revenues were \$44.837 million and consisted primarily of federal capitalization grants and federal recovery funds, which were used to provide grants and loans for water infrastructure projects.

CAPITAL ASSET AND DEBT ADMINISTRATION

Capital Assets

As of June 30, 2012, the State's investment in capital assets was \$42.092 billion, an increase of 4.9% from the previous fiscal year-end (see table below).

Capital Assets as of June 30

(net of depreciation, dollars in thousands)

	Governmental Activities		Business-type Activities		Total	
	2012	2011 (as restated)	2012	2011 (as restated)	2012	2011 (as restated)
Land and permanent easements.....	\$ 15,038,175	\$ 14,397,753	\$ 143,664	\$ 118,255	\$ 15,181,839	\$ 14,516,008
Buildings.....	2,664,959	2,283,382	28,611	29,575	2,693,570	2,312,957
Machinery and equipment.....	569,660	576,835	6,237	6,335	575,897	583,170
Infrastructure:						
State highway system.....	20,330,946	19,532,260	183,936	—	20,514,882	19,532,260
Other infrastructure.....	158,358	132,507	4,907	5,409	163,265	137,916
Computer software.....	28,751	16,701	45	45	28,796	16,746
Art, literature, and other artifacts.....	87,429	87,402	—	—	87,429	87,402
Construction in progress.....	1,865,688	2,232,547	694,181	578,899	2,559,869	2,811,446
Computer software in development....	286,496	128,905	—	—	286,496	128,905
Total.....	\$ 41,030,462	\$ 39,388,292	\$ 1,061,581	\$ 738,518	\$ 42,092,043	\$ 40,126,810
Total percent change between fiscal years 2012 and 2011	4.17 %		43.74 %		4.9 %	

The largest component of capital assets is the State highway system. North Carolina has a 79,415 mile highway system, making it the second largest state-maintained highway system in the nation. The most recent report on the condition of the State highway system (December 2010) noted that while the system continues to grow, the traditional highway maintenance funds have increased, but not enough to keep up with inflation and system growth.

The major capital asset activity during the current fiscal year included the following:

- The N.C. Department of Transportation (DOT) had construction outlays of \$1.9 billion (including land improvements) for State highway projects. Additionally, the N.C. Turnpike Authority (Authority), a separate business unit of DOT, had construction outlays of \$325.5 million for toll road projects. The Authority's largest project is the Triangle Expressway, the State's first modern toll road.
- The Department of Public Safety completed and placed into service a new regional 120 bed medical center (construction cost of \$61.8 million) and 220 bed mental health center (construction cost of \$55.3 million) at Central Prison in Raleigh.
- The Department of Environment and Natural Resources (DENR) completed and placed into service the Green Square Complex (construction cost of \$85.5 million), which consists of office space for DENR employees, the Nature Research Center, and an underground parking deck. This project utilized principles of green building and sustainable design.
- The Department of Health and Human Services (DHHS) is constructing a new psychiatric hospital to replace the existing Cherry Hospital (construction in progress at year-end of \$76.5 million). The new Cherry Hospital is the second of three state-of-the-art facilities that the State has built or will build to replace its aging state-operated psychiatric hospitals. Central Regional Hospital opened in 2008. Construction on a new Broughton Hospital began in 2012. Additionally, DHHS is constructing a new facility that will house the State Laboratory of Public Health and Chief Medical Examiner (construction in progress at year-end of \$66.9 million). The new DHHS construction projects are being financed by special indebtedness bonds approved by the N.C. General Assembly.

As further detailed in Note 22(F) to the financial statements, the State has commitments of \$2.62 billion for the construction of highway infrastructure, which are expected to be financed by gasoline tax collections, motor vehicle fees, federal funds and debt proceeds. Other commitments of \$603.72 million for the construction and improvement of state government facilities are expected to be financed primarily by debt proceeds, state appropriations, and federal funds. More detailed information about the State's capital assets is presented in Note 5 to the financial statements.

Long-term Debt

At year-end, the State had total long-term debt outstanding (bonds, special indebtedness, and notes payable) of \$8.916 billion, an increase of 5.38% from the previous fiscal year-end (see table below).

Outstanding Debt as of June 30 Bonds, Special Indebtedness, and Notes Payable (dollars in thousands)

	Governmental Activities		Business-type Activities		Total	
	2012	2011	2012	2011	2012	2011
General obligation bonds.....	\$ 4,470,500	\$ 4,846,205	\$ —	\$ —	\$ 4,470,500	\$ 4,846,205
Special Indebtedness:						
Lease-purchase revenue bonds.....	30,915	205,045	—	—	30,915	205,045
Certificates of participation.....	557,895	824,860	—	—	557,895	824,860
Limited obligation bonds.....	1,795,090	1,060,745	—	—	1,795,090	1,060,745
GARVEE bonds.....	512,085	373,080	145,535	—	657,620	373,080
Revenue bonds.....	—	—	1,081,183	856,678	1,081,183	856,678
Notes payable.....	35,691	25,038	286,818	269,030	322,509	294,068
Total	<u>\$ 7,402,176</u>	<u>\$ 7,334,973</u>	<u>\$ 1,513,536</u>	<u>\$ 1,125,708</u>	<u>\$ 8,915,712</u>	<u>\$ 8,460,681</u>
Total percent change between fiscal years 2012 and 2011	0.92 %		34.45 %		5.38 %	

During the 2011-12 fiscal year, the State issued \$400 million in limited obligation bonds and \$179.54 million in GARVEE bonds for its governmental activities. The proceeds of the limited obligation bonds will be used to finance various State and university capital improvement projects, which were authorized for special indebtedness financing by previous sessions of the General Assembly. The proceeds of the GARVEE bonds will be used to accelerate funding of various transportation projects identified in the current State Transportation Improvement Plan. Additionally, the N.C. Turnpike Authority (Authority), a business-type activity, issued \$214.51 million in State appropriation revenue bonds and \$145.54 million in GARVEE bonds. The revenue and GARVEE bond proceeds will be used to finance the construction of the Monroe Connector System.

The State refinanced \$382.5 million of its existing debt in fiscal year 2012 to improve cash flow and to take advantage of lower interest rates. By refinancing the debt, the State will reduce its future debt service payments by approximately \$27.3 million over the next 13 years.

The State issues two types of tax-supported debt: general obligation bonds and various types of “special indebtedness” (i.e., debt not subject to a vote of the people). General obligation bonds are secured by the full faith, credit, and taxing power of the State and require approval by a majority of voters. The payments on special indebtedness are subject to appropriation by the General Assembly and may also be secured by a lien on facilities or equipment. The General Statutes (Chapter 142, Article 9) prohibits the issuance of special indebtedness except for projects specifically authorized by the General Assembly. Different forms of special indebtedness, also known as appropriation-supported debt, are authorized. One form, “financing contract indebtedness” includes lease-purchase revenue bonds and certificates of participation and has been used by the State historically. The other form is limited obligation bonds, which may be issued by the State directly rather than through the N.C. Infrastructure Finance Corporation, a conduit issuer. The use of alternative financing methods provides financing flexibility to the State and permits the State to take advantage of changing financial and economic environments. The GARVEEs are a revenue bond-type debt instrument where the debt service is to be paid solely from federal transportation revenues.

The State’s total long-term debt (bonds, special indebtedness, and notes payable) has increased significantly in recent years, rising from \$3.478 billion in 2002 to \$8.916 billion in 2012, in part due to large issuances for higher education capital projects. Prior to 2003, the State only issued general obligation debt. The following is a summary of recent debt authorizations.

Special Indebtedness

The 2009-10 Session of the General Assembly reduced special indebtedness authorizations for various projects by over \$115 million to generate additional debt capacity and increased authorizations for guaranteed energy savings contracts by \$400 million. The 2008-09 Session of the General Assembly authorized the issuance of \$734.03 million of special indebtedness as follows: \$512.22 million for higher education projects, \$109.09 million for correctional facilities, \$50 million for acquiring State park lands and conservation areas, and \$62.72 million for other State projects. The 2007-08 Session of the General Assembly authorized the issuance of special indebtedness as follows: \$481.14 million for higher education projects and \$188.01 million for other purposes. The 2006-07 Session of the General Assembly authorized the issuance of \$672.1 million of special indebtedness as follows: \$429.3 for psychiatric hospitals and a public health laboratory for the Department of Health and Human Services, \$132.2 million for medical and mental health centers for the Department of Correction, and \$110.6 million for other State and university projects.

Repair and Renovation Authorization

The 2002-03 Session of the General Assembly authorized the issuance of \$300 million of special indebtedness to finance the repair and renovation of State facilities and related infrastructure that are supported by the State's General Fund. Of the \$300 million, approximately \$157 million was allocated to the University of North Carolina System. Each of the 16 constituent institutions of the UNC System received a portion of the proceeds for repairs and renovations. The remaining \$143 million of the proceeds was used to make repairs and renovations to various state facilities. The State has issued all of the authorized repair and renovation debt.

Higher Education Authorization

The 1999-00 Session of the General Assembly authorized the issuance of \$3.1 billion of higher education improvement bonds, which were subsequently approved by the voters of the State. The \$3.1 billion bond authorization represents the largest debt authorization in the State's history. The proceeds of these general obligation bonds were used solely to construct new buildings and to renovate and modernize existing buildings on the State's 58 community college and 16 University of North Carolina campuses. These improvements were needed to meet enrollment demands and to ensure that the State's college and university buildings meet modern code requirements and are equipped to prepare graduates for 21st century jobs. The bond legislation passed by the General Assembly specifies the amount of bond funding that flows to each community college and university campus. The State has issued all of the authorized higher education bonds.

Clean Water and Natural Gas Authorization

The 1997-98 Session of the General Assembly authorized the issuance of \$1 billion of clean water and natural gas general obligation bonds, which were subsequently approved by the voters of the State. The bonds proceeds were used to provide grants and loans to local governments for clean water projects (\$800 million) and to provide grants and loans for construction of natural gas facilities to facilitate the expansion of natural gas service to unserved areas of the State (\$200 million). The State has issued all of the authorized clean water and natural gas bonds.

Highway Bond Authorization

The 1995-96 Session of the General Assembly authorized the issuance of \$950 million of highway general obligation bonds, which were subsequently approved by the voters of the State. The bond proceeds were allocated to pay capital costs for urban loops (\$500 million), highways in the Intrastate System (\$300 million), and for paving unpaved roads of the secondary highway system (\$150 million). The State has issued all of the authorized highway bonds.

Credit Ratings

Credit ratings are the rating agencies' assessment of a governmental entity's ability and willingness to repay debt on a timely basis. Credit ratings are an important factor in the public credit markets and can influence interest rates a borrower must pay. The State's general obligation bond credit ratings are as follows:

State of North Carolina General Obligation Bond Credit Ratings		
<u>Rating Agency</u>	<u>Rating</u>	<u>Outlook</u>
Fitch Ratings	AAA	Stable
Moody's Investors Service	Aaa	Stable
Standard & Poor's Rating Services	AAA	Stable

These ratings are the highest attainable from all three rating agencies. In November 2011, all three rating agencies affirmed the triple-A credit rating for the State. A triple-A credit rating means that North Carolina has followed well-defined financial management policies and has demonstrated strong debt management practices. The rating agencies recognized the State's historically conservative budgeting, financial management, and debt issuance practices. North Carolina remains one of only eight states with a triple-A rating from all three rating agencies.

Special indebtedness is not subject to a vote of the people and its repayment is based on the State's annual debt service appropriation. For these reasons, special indebtedness is rated lower than the State's general obligation bonds and typically carries a higher interest rate.

Limitations on Debt

The Constitution of North Carolina (Article 5, Section 3) imposes limitations upon the increase of certain state debt. It restricts the General Assembly from contracting debts secured by a pledge of the faith and credit of the State, unless approved by a majority of the qualified voters of the State, except for the following purposes:

1. To fund or refund a valid existing debt;
2. To supply an unforeseen deficiency in the revenue;
3. To borrow in anticipation of the collection of taxes due and payable within the current fiscal year to an amount not exceeding 50 percent of such taxes;
4. To suppress riots or insurrections; or to repel invasions;
5. To meet emergencies immediately threatening the public health or safety, as conclusively determined in writing by the Governor; and
6. For any other lawful purpose, to the extent of two-thirds of the amount by which the State's outstanding indebtedness shall have been reduced during the preceding biennium.

More detailed information about the State's long-term liabilities is presented in Note 8 to the financial statements.

NEXT YEAR'S BUDGET AND RATES

The 2012 Session of the General Assembly enacted a \$20.2 billion budget for fiscal year 2012-13, a 1.2% increase over the budget originally enacted. Budget adjustments made in the 2012 legislative session focused primarily on Medicaid and public schools. Medicaid received a net increase of \$194 million and, for the first time since 2008, state employees (including state-funded public school teachers) received compensation increases. In an effort to reduce budget cuts scheduled for Local Education Agencies (LEA), the public schools budget was increased by \$143.3 million, reducing the amount of the LEA reduction scheduled for fiscal year 2012-13. There were no major changes in tax rates or fees for fiscal year 2012-13.

REQUESTS FOR INFORMATION

This financial report is designed to provide our citizens, taxpayers, customers, investors and creditors with a general overview of the State's finances and to demonstrate the State's accountability for the money it receives. If you have questions about this report or need additional financial information, contact the North Carolina Office of the State Controller, Accounting and Financial Reporting Section, 1410 Mail Service Center, Raleigh, N.C. 27699-1410. In addition, this financial report is available on the Office of the State Controller's internet home page at <http://www.osc.nc.gov/financial/index.html>.